

**Illinois Department of Revenue
Regulations**

Title 86 Part 100 Section 100.2470	Subtraction of Amounts Exempt from Taxation by Virtue of Illinois Law, the Illinois or U.S. Constitutions, or by Reason of U.S. Treaties or Statutes (IITA Sections 203(a)(2)(N), 203(b)(2)(J), 203(c)(2)(K) and 203(d)(2)(G))
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TITLE 86: REVENUE

PART 100
INCOME TAX

Section 100.2470 Subtraction of Amounts Exempt from Taxation by Virtue of Illinois Law, the Illinois or U.S. Constitutions, or by Reason of U.S. Treaties or Statutes (IITA Sections 203(a)(2)(N), 203(b)(2)(J), 203(c)(2)(K) and 203(d)(2)(G))

- a) In calculating base income, taxpayers are entitled to subtract *an amount equal to all amounts included in such total which are exempt from taxation by this State either by reason of its statutes or Constitution or by reason of the Constitution, treaties or statutes of the United States; provided that, in the case of any statute of this State that exempts income derived from bonds or other obligations from the tax imposed under this Act, the amount exempted shall be the interest net of bond premium amortization* (IITA 203(a)(2)(N)). There are also provisions of Illinois law that exempt the income of certain obligations of state and local governments from Illinois income taxation (see subsection (f)).
- b) Interest on obligations of the United States. A federal statute exempts stocks and obligations of the United States Government, as well as the interest on the obligation(s), from state income taxation (see 31 USCA 3124(a)).
 - 1) "Obligations of the United States" are those obligations issued "to secure credit to carry on the necessary functions of government." *Smith v. Davis* (1944) 323 U.S. 111, 119, 89 L. Ed. 107, 113, 65 S. Ct. 157, 161. The exemption is aimed at protecting the "Borrowing" and "Supremacy" clauses of the Constitution. *Society for Savings v. Bowers* (1955) 349 U.S. 143, 144, 99 L. Ed. 2d 950, 955, 75 S. Ct. 607, 608. *Hibernia v. City and County of San Francisco* (1906) 200 U.S. 310, 313, 50 L. Ed. 495, 496, 26 S. Ct. 265, 266.
 - A) Tax-exempt credit instruments possess the following characteristics:
 - i) they are written documents,
 - ii) they bear interest,
 - iii) they are binding promises by the United States to pay specified sums at specified dates, and
 - iv) they have congressional authorization which also pledges the faith and credit of the United States in support of the promise to pay.

Smith v. Davis, supra.

- B) A governmental obligation that is secondary, indirect, or contingent, such as a guaranty of a nongovernmental obligor's primary obligation to pay the principal amount of and interest on a note, is not an obligation of the type exempted under 31 USC Section 3124(a). *Rockford Life Ins. Co. v. Department of Revenue*, 107 S. Ct. 2312 (1987).
- 2) Based on the above, the following types of income are exempt under 31 USCA Section 3124(a):
 - A) Interest on U.S. Treasury bonds, notes, bills, certificates, and savings bonds.
 - B) Income from GSA Public Building Trust Participation Certificates: First Series, Series A through E; Second Series, Series F; Third Series, Series G; Fourth Series H and I.
- c) Income exempted by reason of other federal statutes. Federal statutes provide exemption from state income taxation with respect to various specifically named types of income. Following is a list (intended to be exhaustive) of exempt income and the specific statutes to which each item relates:
 - 1) Banks for Cooperatives – Income from notes, debentures, and other obligations issued by Banks for Cooperatives (12 USCA 2134).
 - 2) Commodity Credit Corporation – Interest derived from bonds, notes, debentures, and other similar obligations issued by Commodity Credit Corporation (15 USCA 713a-5).
 - 3) Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) – Income from notes, bonds, debentures, and other obligations issued by the Financial Assistance Corporation (12 USCA 2278b-10(b)).
 - 4) Federal Deposit Insurance Corporation – Interest derived from notes, debentures, bonds, or other such obligations issued by Federal Deposit Insurance Corporation (12 USCA 1825).
 - 5) Federal Farm Credit Banks – Income from consolidated system-wide notes, bonds, debentures, and other obligations issued jointly and severally under 12 USCA 2153 by Banks of the Federal Farm Credit System (12 USCA 2023; 12 USCA 207; 12 USCA 2098; and 12 USCA 2134).
 - 6) Federal Home Loan Banks – Interest derived from notes, debentures, bonds, and other such obligations issued by Federal Home Loan Banks and from consolidated Federal Home Loan bonds and debentures (12 USCA 1433).
 - 7) Federal Intermediate Credit Banks – Income from notes, debentures, bonds, and other obligations issued by Federal Intermediate Credit Banks (12 USCA 2079).
 - 8) Federal Land Banks and Federal Land Bank Association – Income from notes, debentures, bonds, and other obligations issued by Federal Land Banks and

Federal Land Bank Associations (12 USCA 2055).

- 9) Federal Savings and Loan Insurance Corporation – Interest derived from notes, bonds, debentures, and other such obligations issued by Federal Savings and Loan Insurance Corporation (12 USCA 1725(e)).
- 10) Financing Corporation (FICO) – Income from obligations issued by the Financing Corporation (12 USCA 1441(e)(8)).
- 11) General Insurance Fund
 - A) Interest derived from debentures issued by General Insurance Fund under the War Housing Insurance Law (12 USCA 1739(d)); or
 - B) Interest derived from debentures issued by General Insurance Fund to acquire rental housing projects (12 USCA 1747g(g)); or
 - C) Interest derived from Armed Services Housing Mortgage Insurance Debentures issued by the General Insurance Fund (12 USCA Section 1748b(f)).
- 12) Guam – Interest derived from bonds issued by the government of Guam (48 USCA 1423a). This income is not presently included in federal taxable income. Under Illinois law, it must be added back to federal taxable income and then claimed as a subtraction on an Illinois income tax return.
- 13) Mutual Mortgage Insurance Fund – Income from such debentures as are issued in exchange for property covered by mortgages insured after February 3, 1988 (12 USCA 1710(d)). This income is not presently included in federal taxable income. Under Illinois law, it must be added back to federal taxable income and then claimed as a subtraction on an Illinois income tax return.
- 14) National Credit Union Administration Central Liquidity Facility – Income from the notes, bonds, debentures, and other obligations issued on behalf of the Central Liquidity Facility (12 USCA 1795K(b)).
- 15) Production Credit Association – Income from notes, debentures, and other obligations issued by Production Credit Association (12 USCA 2098).
- 16) Puerto Rico – Interest derived from bonds issued by the Government of Puerto Rico (48 USCA 745). This income is not presently included in federal taxable income. Under Illinois law, it must be added back to federal taxable income and then claimed as a subtraction on an Illinois income tax return.
- 17) Railroad Retirement Act – Annuity and supplemental annuity payments as qualified under the Railroad Retirement Act of 1974 (45 USCA 231m). Please be sure to use the line specified on your Illinois return for this item.
- 18) Railroad Unemployment Insurance Act – Unemployment benefits paid pursuant to the Railroad Unemployment Insurance Act (45 USCA 352(e)).
- 19) Resolution Funding Corporation – Interest from obligations issued by the

Resolution Funding Corporation (12 USCA 1441b(f)(7)(A)).

- 20) Special Food Service Program – Assistance to children under the Special Food Service Program (42 USCA 1760(e)).
 - 21) Student Loan Marketing Association – Interest derived from obligations issued by the Student Loan Marketing Association (20 USCA 1087-2(h)(221)).
 - 22) Tennessee Valley Authority – Interest derived from bonds issued by the Tennessee Valley Authority (16 USCA 831n-4(d)).
 - 23) United States Postal Service – Interest derived from obligations issued by the United States Postal Service (39 USCA 2005(d)(4)).
 - 24) Virgin Islands – Interest derived from bonds issued by the Government of the Virgin Islands (48 USCA 1574(b)(ii)(A)). This income is not presently included in income taxable federally. Under Illinois law, it must be added back to federal taxable income and then claimed as a subtraction on an Illinois income tax return.
 - 25) American Samoa – Interest on bonds issued by the Government of American Samoa (48 USCA 1670(b)).
 - 26) Northern Mariana Islands – Interest on bonds issued by the Government of the Northern Mariana Islands (48 USCA 1801 note).
- d) Distributions from money market trusts (mutual funds). Taxpayers may subtract income received from any of the obligations listed in subsections (b) and (c), even if the obligations are owned indirectly through owning shares in a mutual fund.
- 1) If the fund invests exclusively in these state tax exempt obligations, the entire amount of the distribution (income) from the fund may be subtracted.
 - 2) If the fund invests in both exempt and non-exempt obligations, the amount represented by the percentage of the distribution that the mutual fund identifies as exempt may be subtracted.
 - 3) If the mutual fund does not identify an exempt amount or percentage, taxpayers may figure the subtraction by multiplying the distribution by the following fraction: as the numerator, the amount invested by the fund in state-exempt U.S. obligations; as the denominator, the fund's total investment. Use the year-end amounts to figure the fraction if the percentage ratio has remained constant throughout the year. If the percentage ratio has not remained constant, take the average of the ratios from the fund's quarterly financial reports.
- e) Getting a refund of tax you already paid. If you paid Illinois income tax on these state tax exempt distributions, you may file an amended return (IL-1040-X) to claim a refund for any year still within the statute of limitations.
- f) Interest on obligations of state and local governments. Income from state and local obligations is not exempt from Illinois income tax except where authorizing legislation adopted after August 1, 1969, specifically provides for an exemption. To date,

authorizing legislation provides exemption for the income from the securities listed below. Taxpayers must show income from these exempt bonds as an addition and then as a subtraction on the Illinois income tax return. Income from these bonds is not exempt if the bonds are owned indirectly through owning shares in a mutual fund.

- 1) Notes and bonds issued by the Illinois Housing Development Authority (except housing-related commercial facilities notes and bonds) [20 ILCS 3805/31].
- 2) Bonds authorized pursuant to the Export Development Act of 1983 (former Ill. Rev. Stat. 1991, ch. 127, par. 2513, repealed by P.A. 87-860, effective July 1, 1992).
- 3) Bonds issued by the Illinois Development Finance Authority pursuant to Sections 7.50 - 7.61 (venture fund and infrastructure bonds) [20 ILCS 3505/7.61, repealed by P.A. 93-205, effective January 1, 2004, which provides in 20 ILCS 3501/845-60 that bonds issued under this provision continue to be exempt from taxation].
- 4) Bonds and notes issued by the Quad Cities Regional Economic Development Authority, if the Authority so determines [70 ILCS 510/11, 510/13, 515/11, and 515/12].
- 5) College Savings Bonds issued under the General Obligation Bond Act in accordance with the Baccalaureate Savings Act [110 ILCS 920/7].
- 6) Bonds issued by the Illinois Sports Facilities Authority [70 ILCS 3205/15].
- 7) Bonds issued on or after September 2, 1988, pursuant to the Higher Education Student Assistance Act [110 ILCS 947/145] (transferred from 105 ILCS 5/30-15.18 by P.A. 87-997).
- 8) Bonds issued by the Illinois Development Finance Authority or the Illinois Finance Authority under the Asbestos Abatement Finance Act [20 ILCS 3510/8].
- 9) Bonds and notes issued under the Rural Bond Bank Act [30 ILCS 360/3-12, repealed by P.A. 93-205, effective January 1, 2004, which provides in 20 ILCS 3501/845-60 that bonds issued under this provision continue to be exempt from taxation].
- 10) Bonds issued pursuant to Sections 7.80 - 7.87 of the Illinois Development Finance Authority Act [20 ILCS 3505/7-86, repealed by P.A. 93-205, effective January 1, 2004, which provides in 20 ILCS 3501/845-60 that bonds issued under this provision continue to be exempt from taxation].
- 11) Bonds issued by the Quad Cities Interstate Metropolitan Authority under the Quad Cities Interstate Metropolitan Authority Act [45 ILCS 35/110].
- 12) Bonds issued by the Southwestern Illinois Development Authority pursuant to the Southwestern Illinois Development Authority Act [70 ILCS 520/7.5].
- 13) Bonds issued by the Illinois Finance Authority under the Local Government Article and the Financially Distressed City Program in the Illinois Finance Authority Act [20 ILCS 3501/820-60 and 825-55].

g) Other income exempt from Illinois income taxation by reason of Illinois statute:

- 1) Income earned by certain trust accounts established under the Illinois Pre-Need Cemetery Sales Act [815 ILCS 390/16]. Section 16(f) of the Illinois Pre-Need Cemetery Sales Act provides that: *because it is not known at the time of deposit or at the time that income is earned on the trust account to whom the principal and the accumulated earnings will be distributed, for purposes of determining the Illinois Income Tax due on these trust funds, the principal and any accrued earnings or losses relating to each individual account shall be held in suspense until the final determination is made as to whom the account shall be paid.*
- 2) Income in the form of education loan repayments made for primary care physicians who agree to practice in designated shortage areas for a specified period of time under the terms of the Family Practice Residency Act [110 ILCS 935/4.10].
- 3) Income earned by nuclear decommissioning trusts established pursuant to Section 8-508.1 of the Public Utilities Act [220 ILCS 5/8-508.1]. The terms *"Decommissioning trust" or "trust" means a fiduciary account in a bank or other financial institution established to hold the decommissioning funds provided pursuant to Section 8-508.1(b)(2) of the Public Utilities Act for the eventual purpose of paying decommissioning costs, which shall be separate from all other accounts and assets of the public utility establishing the trust.* [220 ILCS 5/8-508.1(a)(3)]
- 4) Income from the Illinois prepaid tuition program, other than disbursements to beneficiaries which are not used in accordance with the applicable prepaid tuition contract under the Illinois Prepaid Tuition Act [110 ILCS 979]. The Illinois prepaid tuition program was created in 1997 for the express purpose of allowing savings for higher education to earn tax-exempt returns under Section 529 of the Internal Revenue Code. If a prepaid tuition contract qualifies under Section 529, earnings on contributions made to the Illinois Prepaid Tuition Trust Fund under the contract are exempt from federal income taxation (and therefore Illinois income taxation) until distributed. The legislative intent in creating the Illinois prepaid tuition program does not guarantee that every prepaid tuition contract will qualify under Section 529 and there is no guarantee that Section 529 will continue in effect. However, Section 55 of the Illinois Prepaid Tuition Act [110 ILCS 979/55] provides that *assets of the Illinois Prepaid Tuition Trust Fund and its income and operation shall be exempt from all taxation by the State and that disbursements to a beneficiary shall be similarly exempt from all taxation by the State of Illinois and any of its subdivisions, so long as they are used for educational purposes in accordance with the provisions of an Illinois prepaid tuition contract.* Under this provision, any undistributed earnings of the Illinois Prepaid Tuition Trust which are included in a taxpayer's federal taxable income or adjusted gross income because a prepaid tuition contract does not qualify under Section 529 may be subtracted in computing the taxpayer's base income, and all disbursements included in a beneficiary's adjusted gross income may be subtracted to the extent used in accordance with the Illinois prepaid tuition contract under which the disbursements are made, regardless of whether the prepaid tuition contract qualifies under Section 529.

- 5) Income from the College Savings Pool, other than disbursements to beneficiaries that are not used to pay qualified expenses under the State Treasurer Act [15 ILCS 505/16.5]. Under the State Treasurer Act, distributions from the College Savings Pool must generally be used for *qualified expenses*, which are defined to mean *tuition, fees, and the costs of books, supplies, and equipment required for enrollment or attendance at an eligible educational institution and certain room and board expenses*. Distributions made for qualified expenses must be made *directly to the eligible educational institution, directly to a vendor, or in the form of a check payable to both the beneficiary and the institution or vendor*. The College Savings Pool was created in Public Act 91-607 for the express purpose of allowing savings for higher education to earn tax-exempt returns under Section 529 of the Internal Revenue Code. If an investment in the College Savings Pool qualifies under Section 529, earnings on that investment are exempt from federal income taxation (and therefore Illinois income taxation) until distributed. The legislative intent in creating the College Savings Pool does not guarantee that investments will qualify under Section 529 and there is no guarantee that Section 529 will continue in effect. However, the State Treasurer Act [15 ILCS 505/16.5], as amended in Public Act 91-829, provides that *assets of the College Savings Pool and its income and operation shall be exempt from all taxation by the State* and that disbursements to a beneficiary *shall be similarly exempt from all taxation by the State of Illinois and any of its subdivisions, so long as they are used for qualified expenses*. Under this provision, any undistributed earnings of the College Savings Pool that are included in a taxpayer's federal taxable income or adjusted gross income because a College Savings Pool investment does not qualify under Section 529 may be subtracted in computing the taxpayer's base income, and all disbursements included in a beneficiary's adjusted gross income may be subtracted to the extent used to pay qualified expenses, regardless of whether the College Savings Pool investment qualifies under Section 529.
- 6) Income earned on investments made pursuant to the Home Ownership Made Easy Program [310 ILCS 55/5.1].
- 7) Up to \$2,000 of income derived by individuals from investments made in accordance with College Savings Programs established under former Section 30-15.8(a) [105 ILCS 5/30-15.8(a)] (see subsection (f)(7)).
- h) Income not exempt from Illinois income taxation. The following types of income are not exempt from Illinois income taxation:
 - 1) Income from securities commonly known as GNMA "Pass-Through Securities" and also known as GNMA "Mortgage-Backed Securities" issued by approved issuers under 12 USCA 1721(g) and guaranteed by GNMA under 12 USCA 1721(g) (Rockford Life Insurance Co. v. Department of Revenue, 112 Ill.2d 174, 492 N.E. 2d 1278 (1986), reh. den. June 2, 1986) and income from debentures, notes, and bonds issued by the Federal National Mortgage Association including mortgage-backed bonds issued under authority of 12 USCA 1719(d) and guaranteed by GNMA under 12 USCA 1721(g).
 - 2) Accumulated interest on Internal Revenue Service tax refunds. Illinois Department of Revenue Letter Ruling No. 86-0640, dated July 11, 1986, citing Glidden Co. v. Glander, 151 Ohio St. 344, 86 N.E. 2d 1, 9 A.L.R. 2d 515 (1949).

- 3) Income from U.S. securities acquired by a taxpayer under a repurchase agreement ("repo") with a bank or similar financial organization. The Department takes the position that, for income tax purposes, such agreements are generally to be treated as loans. That is, the taxpayer "loans" money to the bank and receives interest in return. The securities subject to repurchase by the bank serve as collateral for the loan. The bank remains legally entitled to receive the interest payments from the issuing authority and remains the actual owner of the securities. Therefore, any tax benefit attributable to the "exempt" income paid by the issuing authority accrues to the bank and not to the investor.
- 4) Section 514(a) of the Employee Retirement Income Security Act of 1974 (ERISA, 29 USC 1144(a)) does not preempt the taxation of unrelated business income of an Employee Benefit Plan governed by ERISA. *Buono v. NYSA-ILA Medical and Clinical Services Fund*, 520 U.S. 806, 808 (1997). Taxpayers that relied upon the Department's letter rulings IT 90-0073, IT 93-0017 and IT 93-0187, prior to July 1, 2002, shall not incur liability for taxes or penalties pursuant to Section 4(c) of the Taxpayers' Bill of Rights Act [20 ILCS 2520].
- i) Method for computing the subtraction of exempt income. The Department emphasizes that before a taxpayer may subtract an item of exempt income, the taxpayer must be sure that he or she has included the item in Illinois income. Some tax-exempt items are "automatically" included in base income because they are included in federal adjusted gross income, which is a part of base income. Interest on U.S. Treasury notes is in this category. Other exempt items must be included as an addition on the Illinois tax return in figuring base income. In other words, the taxpayer must list certain tax-exempt items as additions and then as subtractions in figuring base income. Interest on the state and local government bonds described in subsection (f) is in this category.

(Source: Amended at 31 Ill. Reg. 16241, effective November 26, 2007)